



Early Journal Content on JSTOR, Free to Anyone in the World

This article is one of nearly 500,000 scholarly works digitized and made freely available to everyone in the world by JSTOR.

Known as the Early Journal Content, this set of works include research articles, news, letters, and other writings published in more than 200 of the oldest leading academic journals. The works date from the mid-seventeenth to the early twentieth centuries.

We encourage people to read and share the Early Journal Content openly and to tell others that this resource exists. People may post this content online or redistribute in any way for non-commercial purposes.

Read more about Early Journal Content at <http://about.jstor.org/participate-jstor/individuals/early-journal-content>.

JSTOR is a digital library of academic journals, books, and primary source objects. JSTOR helps people discover, use, and build upon a wide range of content through a powerful research and teaching platform, and preserves this content for future generations. JSTOR is part of ITHAKA, a not-for-profit organization that also includes Ithaka S+R and Portico. For more information about JSTOR, please contact support@jstor.org.

FEDERAL TAXES UPON INCOME AND EXCESS PROFITS

BY T. S. ADAMS
Yale University

The subject allotted to me is a large one and I have attempted little more in the following paper than to state some of the larger problems and the solutions which at this time seem most promising. It is necessary to add, moreover, that I express only my own personal opinions.

I. *Nature of the Excess-Profits Tax*

The first American excess-profits tax (of March 3, 1917) was a moderate, flat tax on the income of corporations and partnerships in excess of 8 per cent upon actual capital invested; it was later changed by the Senate Finance Committee to a tax on war profits; and finally after protracted discussion was changed back to a highly graduated tax on the "supernormal" income of individuals, partnerships, and corporations. The excess-profits tax in its present form represents a conscious and deliberate victory of the excess-profits principle over the war-profits principle.

The conviction that carried the day for the excess-profits principle was the knowledge that, adventitiously, some industries (e.g., the automobile industry) were exceptionally prosperous just before the war, while some other industries (e.g., the textile and lumber industries) were in an abnormally depressed condition during the "pre-war period." Congress apparently saw no reason why the industry which was exceptionally prosperous just before the war should on that account be immune from taxation during the war. Pre-war prosperity can establish no just ground for exemption during the war.

This was the principal judgment registered by the adoption of the war excess-profits tax of October 3, 1917. Congress decided to lay a special tax on "supernormal" income, whether the taxpayer chanced to have made exceptionally high or exceptionally low profits during the three years 1911-13. At the same time Congress decided to measure normal income as a part or percentage of invested capital, and not as an average of past profits. The latter decision I regard as of secondary importance. In the future it is not improbable that we shall employ past earnings as

the chief determinant of invested capital. In essence there is little difference between an income and a capital basis. But there is a vast difference between a war-profits and a supernormal income tax.

One important aspect of this difference has to do with the possible permanence of the tax. If we measure the excess to be taxed as the difference between income during the war and the income just before the war, the tax is essentially temporary. The basis would become more illogical with each passing year and the tax would be likely to disappear with the war which created it. But if we succeed in determining what is the normal income (either as a percentage of the invested capital or in any other way) and lay the tax upon the net income in excess of that normal return, we have a tax that may permanently endure. It represents, as it were, the share of the state in the "supernormal" success of every business enterprise. It measures roughly the value of the facilities, opportunities, and environment provided by the community.

The excess-profits tax is primarily a business tax and its real nature can best be explained by a consideration of the most searching criticism directed against it: the criticism that it violates the great principle of ability to pay. Let me borrow an illustration and a discussion which I have used elsewhere. Here are two corporations each with the same capital and the same net earnings, but corporation A is owned by a large number of small investors (workingmen and mechanics, perhaps), while corporation B is owned by a few millionaires. Drastic taxes upon the profits of A and B will have very different effects upon the two sets of stockholders. The mechanics and workingmen who jointly own corporation A will be deprived of extra war dividends which they may really need to meet the increased cost of living; whereas the owners of B will merely be deprived of unnecessary luxuries or the wherewithal to make new investments. The challenge or criticism under discussion amounts then to this: that an income or excess-profits tax of any variety upon a business unit is illogical; that its principal incidence and burden are upon the stockholders; that there may be relatively strong stockholders in weak corporations and very weak stockholders in strong corporations; that so far as possible we should avoid the intermediary, the go-between, and employ only the personal income tax. At the basis of this criticism will be found an assumption, conscious or un-

conscious, that all direct taxes are to be approved or condemned according as they conform to or depart from the ability standard.

But it is a shallow interpretation of the ability principle that tests its every application by the effect of the tax upon the consumer, which surveys the taxpayer only as one who clothes his back and feeds his body. There are many valid varieties of the ability principles and among them are those which survey the taxpayer in his capacity of producer, which recognize the reality of a composite business unit, which appreciate the truth that the state and community stand as silent partners in every business enterprise.

Most good business taxes represent or express at once both the ability and benefit principles. The English excess-profits tax represents, according to the English courts, the share of the state in the profits of private business; and the similar American tax is designed, I believe, to achieve the same purpose. It is not a tax upon the individual, to be judged by the sacrifices which it imposes upon him, but the prior claim of the state upon profits which public expenditures or the business environment maintained by the state have in part produced. The government's claim to part of the profits, particularly in time of war, is so strong as to justify the statement that the stockholders have no claim on the profits until the government has released them. When a special assessment or betterment tax is imposed, no cognizance is taken of the individual's ability to pay. For much the same reason, when an excess-profits tax is levied upon a corporation or partnership, no cognizance need be taken of the tax-paying ability of the shareholders.

And yet, business taxes are not antagonistic to the ability principle. They recognize, like the betterment tax, a species of ability to pay created by the activities of the community or by a "conjuncture" maintained by the state. The state or the community creates, as it were, the fund from which the tax is taken. Business concerns, furthermore, do possess an organic unity; they are, when compared with one another, less able or more able to pay; the ability standard does apply to them as corporate or business entities.

I have spoken of the possibility that the excess-profits tax will become a permanent feature of the federal tax system. After the war there is likely to be a strong agitation for increased customs duties. It is not unlikely at that time that the excess-profits tax

will be used by the opponents of protection as a financial antidote. The needed revenues can be raised—it will be asserted—more equitably by direct taxes upon supernormal income than by indirect taxes trenching upon the necessities of the poor.

But the curious fact is, that if protectionistic doctrines prevail, the case will be just as strong for the excess-profits tax. If the government by taxing the people to protect American industry helps to bring exceptional profits to particular industries, there will arise a vigorous demand to take back some of these profits for the benefit of the people which taxes itself to protect private industry. I make no prophecies and express no settled conclusions. But next in importance to winning this war is the maintenance of a liberal and democratic financial policy during the reconstruction period which must follow the war. The much discussed question of bonds versus taxes in war finance is not only less important than the general character of the tax system which is to follow the war, but the solution of the bond question depends upon the character of our postbellum tax policy.

It is sometimes said that the country which imposes an excess-profits tax after the war will so hamper its business as to deny it any share in the international trade of the world—in short, that it will place domestic industry at a disadvantage in competing with foreign industry.

Whether this criticism be sound or unsound depends on many factors, among which must be included the relative burden of all taxation in this country as contrasted with the similar aggregate burden in foreign countries; the equity and care with which this and other taxes are formulated and administered; most of all upon the truth of the theory upon which the tax rests. It is asserted that the success of business enterprise depends, in part, upon the helpful coöperation of the state. This is either genuine truth or political humbug. If it is a genuine truth, business can afford to pay for the assistance rendered by the state. If it is merely hollow rhetoric, American business enterprise will fall before foreign competitors which have the real support of their respective governments.

Moreover, the excess-profits tax may in the future serve appreciably to allay hostility to big business, by making the people a partner in the success of business enterprise. As pointed out several years ago by Henry C. Adams, such a tax fits in harmoniously with the policy of rate regulation or price regulation.

We shall probably have more such regulation as time passes; and this regulation must, in all probability, be accomplished through general rules which, adapted to less favorably situated producers, yield excessive returns to the more favorably situated producers. Under such circumstances, a tax upon excess-profits makes the results of price regulation more equitable and more attractive. This device, moreover, would appear to promote individualism and private industry. Not only land sites, as Henry George emphasized, but other commercial and industrial opportunities differ enormously. We cannot give to each industry the same opportunities of location, proximity to markets, good shipping facilities, good credit institutions, and good government; but we can make the inequalities a little less by imposing a tax upon their differential product—upon excess profits. Conceivably then, the excess-profits tax may assist materially to promote that equality of opportunity which is as necessary to good business as to good citizenship.

Lack of productivity will probably prove the gravest weakness of the excess-profits tax as a permanent part of the tax system. In normal years we cannot expect a tax upon supernormal profits to yield the enormous revenue which we expect to derive from this source during the war. And yet, it is probable that even in lean years the tax would supply a revenue altogether worth while. In our vast country it seldom or never happens that all sections and all industries move together. When there is drought or financial depression in one part of the country, other sections enjoy abundant crops. Where an epidemic prevails, the doctors at least do a thriving business. There will always be some excess profits to tax.

II. *Scope and Place of the Excess-Profits Tax*

The excess-profits tax covers business profits, salaries and the like, but not the income of the investor. There is some doubt about this interpretation of the law, but it is probably the correct interpretation. The corporation and partnership are taxable upon all profits from whatever source derived. But the individual is not taxable upon income derived from the mere ownership of property. The "gentleman of leisure," the man who happily "lives upon his income" escapes.

All this is logical enough in one sense. Dividends are properly exempt to the stockholder, at least in part, and most other invest-

ment income, excepting certain royalties which vary with prices, is not abnormally high at the present time. It would, if subject to excess-profits tax, escape under the 7-9 per cent deduction; and the inclusion of the principal in "invested capital" would operate to reduce the tax from other sources. England explicitly exempts investment income from her excess-profits tax.

Nevertheless, this exemption of the investor does not leave a pleasant taste in the mouth. Part of the normal tax upon bond interest is usually paid at the source and does not reach the investor or creditor at all. Moreover, the change in the income tax by which dividends hereafter take the surtax rates applicable to the year in which the income (from which such dividends are paid) was earned by the corporation, may bring it to pass that a large part of the dividends taxed in 1918 will bear the low peace rates prevailing in 1916. The investor, moreover, largely escapes state and local taxes on his investments.

There seems no reason, then, why the government should deal more leniently with the investor than with the individual whose earnings arise from his personal talent and ability (which perish with him), or the active business man who stakes his time and capital in the hazardous game of competitive business. Theoretically I believe the situation requires two remedies. Many royalties, to take a single example, depend upon market prices, so that at present these royalties are abnormally high. In these and similar cases there is a supernormal investment income which should, if possible, be subject to the excess-profits tax. It would be superfluous, perhaps, to bring investment income under the present law with its 7-9 per cent deduction. But this merely means that the 7-9 per cent deduction is too inelastic to fit the complex facts of the situation. A 9 per cent deduction is unduly high for some forms of income and unduly low for others. It is the old question of what constitutes a "fair return," and the excess-profits tax will never be perfect until the principal deduction is adjusted to the variations of this "fair return" in different lines of investment.

The other remedy is a higher tax upon "earned income." Nothing very complicated should be attempted, but it would be a comparatively easy matter to insert in the income tax a differential or additional rate upon dividends, interest, royalties, and some other forms of assured income.

Salaries and earnings from personal service.—The famous 8

per cent "joker" clause of the excess-profits tax was added by the unanimous action of the Conference Committee, in the belief that there was no such difference between business profits on the one hand and personal earnings on the other hand as to warrant the heavy taxation of the one and the complete exemption of the other. Why, it was asked, should the farmer pay excess-profits tax and the lawyer and the bank president be exempt? Personally I am aware of no satisfactory answer to that question.

The tax obviously should be laid upon supernormal income from personal service. But what is a supernormal salary, or the supernormal earnings of an engineer? It might not be difficult to determine this in the case of a middle-aged professional man who has reached the limit of his earning capacity. But it would be very difficult to employ any pre-war basis for the young professional man whose salary may for obvious reasons be rising rapidly with the passing years. Offhand, I think of no better method for measuring this tax than by the application of a graduated rate to net income above a reasonably liberal exemption. This element of the excess-profits tax might easily be incorporated with the ordinary additional taxes on net income. But on the whole it is preferable to keep the excess-profits tax on personal earnings separate. It makes it plain that the excess-profits tax does apply to personal earnings as well as to business profits.

Business profits.—The preceding discussion of salaries calls attention to the fact that, whereas corporations are authorized to deduct the salaries which they pay to officers who are also stockholders, partnerships and sole traders enjoy, in the opinion of many authorities, no similar right. Just what ruling the Treasury Department will make on this moot point it is impossible now to predict; but if the Department finds itself powerless under the law to recognize a reasonable salary allowance in the case of partnerships and sole traders, it will expose the latter to a very grave disadvantage in their competition with concerns organized as corporations. The matter is important because salaries and similar incomes are subject only to the 8 per cent rate.

A much greater discrimination is found in the fact that the heavy additional income taxes do not apply to corporations. The partner or the sole trader is compelled to pay the additional income tax upon his entire share of the profits whether these profits remain in the business or not. But the corporation pays only the normal income tax on its net income and the shareholder

therein pays upon his dividends only when they are received. Various devices have been introduced to neutralize this inequality. The normal tax upon corporations is 6 per cent, as contrasted with the 4 per cent rate applicable to individuals. The individual and the partnership are given a specific deduction of \$6000 under the excess-profits tax, whereas the similar deduction of the corporation is only \$3000. The individual and the partnership, moreover, enjoy a more liberal interest deduction than the corporation. Finally, an additional tax of 10 per cent is imposed upon the profits of every corporation remaining undistributed six months after the end of the business year; but this tax does not apply to that portion of the undistributed net income which is actually retained for employment in the reasonable requirements of the business or is invested in obligations of the United States issued after September 1, 1917. It was frequently stated in the Senate, when the adoption of this tax was under discussion, that the sweeping exceptions which it recognizes practically render it nugatory.

This question of taxing undistributed earnings carries us to the very heart of the difficult subject of business taxation. The best corporations of the country are probably our largest and most effective savers. Careful estimates indicate that the undistributed profits of corporations alone in the year 1917 exceed five billion dollars, practically all of which is reinvested in productive industry. To apply to this fund the heavy super-taxes authorized in the general income tax, would be a very serious matter.

But what is sauce for the goose should be sauce for the gander. Should not the sole trader and partnership enjoy the same privilege as the corporation? Unfortunately we cannot answer this question lightly in the affirmative. To say to every business man that the income tax is to apply only to amounts withdrawn from his business would seriously impair the productivity of the income tax. Moreover, if the corporation, partnership, and the active business man are to be taxed only on the sums withdrawn for consumption, we should be logically compelled to exempt all salaries and other personal income which is reinvested or saved. And we could not stop here. Much of our consumption is productive. We could not consistently exempt profits reinvested in the saloon business and tax the average citizen upon the savings which he invests in the education of his children.

This is an old, old topic with the economist, and the answer is difficult. But the answer cannot be that we should tax only un-

productive consumption. Fiscal necessity—and personally I believe logic as well—requires the taxation of all profits whether reinvested or not. In short, the undivided profits of a corporation should be taxed at the rates which would apply if such profits were distributed to the shareholders. This would permit and justify some reduction in the present super-tax rates, except perhaps in the case of unearned income. Along with this reduction in rates should go a more scientific and liberal treatment of some business expenses, such as the interest deduction and the allowances for obsolescence and amortization of war plant and equipment. Certainly we cannot continue to put so large a premium on the corporate form of business enterprise.

Nominal capital.—The treatment of salaries and other income from personal services under the excess-profits tax is peculiar. Such incomes are not mentioned in the law *eo nomine*, and the section which controls them—Section 209—applies in general to the case of any “trade or business having no invested capital or not more than a nominal capital.” The definition of invested capital provided by the law is such that there is likely to be, in addition to taxpayers deriving their income from personal services, a considerable number of other business concerns with no invested capital or not more than a nominal invested capital. Concerns with large intangible assets, those whose tangible property has greatly appreciated in value since the original investment, and in general all concerns whose invested capital is reduced to a nominal amount by the restrictive clauses of the capital definition, may be brought under Section 209 and be thus entitled to the 8 per cent rate.

This is out of the frying pan into—comparative immunity. The 8 per cent rate is fairly satisfactory for personal earnings, but is too low for concerns whose profits are derived largely from unrecognized intangibles. The easiest remedy would be to restrict Section 209 to salaries and other income from personal service, and to place concerns whose invested capital is reduced to a nominal amount through the operation of the restrictive clauses of the capital definition under Section 210.

III. *Definition of Invested Capital*

The foundation of the whole law is the famous or infamous definition of invested capital.

The usual and most searching criticism of this definition starts

with the assertion that the invested capital rests upon the original investment. The original investment, it is asserted, has no meaning in the case of mature corporations and partnerships. It changes ceaselessly. Tangible property appreciates and depreciates; intangible assets are constantly developing or constantly wasting away. Whether a given concern shall obtain recognition of its intangible assets—so the criticism runs—depends largely upon the character of its accounting; upon the fortuitous fact that a reorganization has or has not taken place; or upon the manner in which the reorganization may have been effected. The capital definition penalizes the sole trader and the partnership, it is charged, as compared with the corporation; it penalizes the small corporation as compared with the large corporation, and the conservative corporation as opposed to the stock-watered type, which the promoter has made odious.

This criticism is exaggerated. "Invested capital" recognizes, it must be remembered, paid-in surplus as well as earned surplus and undivided profits. Much can be done with this clause relating to surplus and undivided profits. A considerable proportion of American corporations have been deliberately under-capitalized. It will be possible under the law in many cases to rectify this under-capitalization. Where assets of great value, for instance, have been paid in for a nominal amount of capital stock, the unrecorded residue can in many instances be recognized as paid-in surplus. Again where ultra-conservative accounting has led to over-depreciation or to the charging of capital assets as current expense, it is possible to recognize the facts of the situation by reconstructing the surplus and undivided profits accounts. In other words the definition of invested capital is simply not open to some of the cruder and more thoughtless criticisms which have been directed against it. In a large majority of cases—I should guess not less than 70 per cent—the book value of the capital represents the fair value of the capital, and this amount will be recognized as "invested capital" under the law.

But it is difficult to see how under Section 207, which defines invested capital, anything can be done where the true capital as it exists today is seriously above the statutory "invested capital," either by reason of great appreciation in value or by reason of the upbuilding of intangible assets of great value through expenditures for advertising and the like. The recognition of appreciation before it is realized by sale, appears to be discountenanced by

our higher courts, although there is one recent decision to the contrary. And it appears to be administratively impossible to permit taxpayers to build up intangible assets from the specific expenditures for advertising and the like which they have made in the past. Nobody can tell with certainty in the ordinary case whether such expenditures have been made for maintenance or for capital development; and as often as not good will, brands, trademarks, and the like are built up or developed by good workmanship and the scrupulous maintenance of quality. The reconstruction of capital accounts, so far as most intangibles are concerned, is too problematical, in all probability, to receive administrative sanction.

Yet to deny all recognition to such intangible assets would create grave inequalities and cause many glaring instances of the "unlike treatment of like situations." Corporation A will receive recognition of its appreciation and intangibles because it happened to reorganize a few years ago. Corporation B will be unable to include its appreciated or intangible assets because it has never gone through the formal process of reorganization and has handled its accounts conservatively. Not to provide for cases of this kind would be gratuitous neglect.

It is sometimes stated that appreciation should not be recognized because it has not been subjected, as a gain, to income tax; and that built-up intangibles deserve no place because the corresponding developmental expenditures have been charged to current expense. The answer would seem to be that the appreciation may have taken place, and the intangibles may have been developed, long before income taxation of any kind was introduced into the federal scheme of taxation. Moreover, in the early years of the corporation excise income tax, appreciation was taxed when recognized in the accounts of the corporation.

The best remedy for this and similar cases of inequality would be the creation of some agency charged with the general power and duty of equalization. The English law, after specifying certain exceptional cases entitled to separate treatment on their respective merits, authorizes the appointment of a board of referees with power to "increase the statutory percentage or alter the percentage standard for the class of trade or business the subject of the order, or alter the pre-war standard or percentage, as the case requires." It is hardly too much to say that, under the English law, the Commissioners of Inland Revenue together with

the Board of Referees may practically adapt the law to the exigencies of any special case. This is the safety valve of the great English law. Probably we could not invest an administrative board with so much discretion in this country. But there is ample legislative precedent for the creation of a federal board of equalization endowed with powers to relieve marked inequalities.

These well recognized cases of inequality could, if necessary, be dealt with under the provisions of Section 210. This section as it now stands is curiously defective; but it was meant almost certainly to empower the Secretary of the Treasury to work back from the income of the corporation in doubtful cases and assess a tax (to state it roughly) which should bear the same relation to the net income of the particular taxpayer as the average tax assessed (in the ordinary way) upon representative corporations in the same business bears to the average net income of such representative corporations. This is a rough and ready method of equalization—but it is better than no method. At present the section is not only incomplete, but it applies only to cases in which the Secretary of the Treasury is unable satisfactorily to determine the invested capital. It should be perfected and if possible extended to permit the correction of specified cases of inequality. It might by a few mandatory words be made the most important section of the law—a corrective and equalizer which would go far to remedy most of the evil possibilities inherent in the law as it now stands.

In the last analysis, however, we inevitably come back to the primary question. Can capital with all its uncertainties, its dependence upon the proper distinction between current expense and capital outlays, its sensitive reactions to depreciation and appreciation, its varying productivity according as it is used with effective or ineffective brains and man power—can such a thing serve as the sure foundation for what is expected to be the most important tax ever levied by the federal government? Are we building upon rock or upon the shifting sands?

This is the much mooted question of the capital *versus* the pre-war profits standard. In attempting to answer it we must first of all remember that under any system we are forced to use the capital basis (a) in the case of business concerns organized since the outbreak of war, (b) in the case of many industries which were in a confessedly abnormal condition during the pre-war period, and (c) in the case of all industries so far as capital additions made since the beginning of the war are concerned.

Passing to more fundamental considerations, the controlling factor is found in the purpose of the excess-profits tax. Its essential purpose is to lay a graduated course upon supernormal earnings; and its fundamental problem is to determine the fair return upon actual investment, ignoring war aberrations. The "fair return" we know, or can ascertain without insuperable difficulty from the data already accumulated in the archives of the Bureau of Internal Revenue. The "actual investment" must be determined in a variety of ways.

Every appraiser knows that in some cases it is easier to work back to capital values from past earnings, than to compute such values directly from market prices. In such cases full use should be made of past income. Here is the true place and service for "pre-war profits." In other cases capital values are only remotely connected with the past earnings of the business concern in question. Here we should ignore "pre-war profits." In general, however, full use should be made of the convenient fact that in the average case capital is the summary expression of normal earnings—normal earnings caught and fixed in an instantaneous photograph of what otherwise would have to be portrayed on a long and intricate reel of historical film. Capital—the actual capital that we want for excess-profits taxation—is normal earnings capitalized.

Obviously it must be a real invested capital however, not the conventional thing recorded in many books of account, but an invested capital which submits itself to the facts of growth and decay. The great difficulty is to start right. If we can but make a correct start, proper accounting, stimulated and controlled as it is by the income tax, will in the future make the tax easier to administer with each passing year.

IV. *The Income Tax*

The income tax is so old a subject with economists that I shall touch only upon some of the changes which have been made in the new War Revenue Act.

1. Many of these changes represent improvements often recommended by members of this Association. The tax has been made more democratic and more wholesome by reducing the exemptions. Deductions for children and dependents have been authorized. The system of collection at source has been almost entirely replaced by a system of information at source. Income

taxes paid in one year can no longer be deducted as expenses of the next year; and the tax is given a new status as the government's share in the earnings of capital and labor. Our new bonds and treasury certificates have been subjected to surtaxes and excess-profits taxes; while interest upon indebtedness incurred for the purchase of tax-free securities can no longer be deducted.

These modifications represent decided improvements. Other changes are of more doubtful character. A specific prohibition of contracting-out (i.e., the adoption of covenants by which the debtor undertakes to pay all taxes paid at source upon the debt or the interest thereon) contained in the Senate bill was stricken out by the Conference Committee, thus providing official sanction for a practice which most foreign laws forbid. Worst of all, a new method of taxing dividends has been introduced, which provides in brief that "any distribution made to the shareholders . . . of a corporation . . . shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation. . . ."

This new method of taxing dividends will entail much administrative trouble and expense, and will eventually give rise to insoluble administrative problems. The tax rates prescribed by law for any particular year have no meaning except as applicable to individuals with net incomes of specified amounts. This is necessarily true of a graduated income tax. In time dividends will be paid out of earnings of 1917 to shareholders who were not alive in that year. Many of the dividends paid this year and taxed in 1918 will take the low 1916 rates. In the future when the practical unworkability of this provision is demonstrated it is likely that the whole scheme will be repealed. Its net effect, therefore, will be to shield from the high war rates, temporarily at least, many investors whose incomes consist principally of dividends. This leniency towards the investor was probably not the result of legislative premeditation, but—taken in connection with the failure of the excess-profits tax to reach investors—it will probably hasten the introduction of a surtax on "unearned income."

2. Unfortunately also, the law still suffers from a number of blemishes which, entering into both excess-profits and income taxes

at the high war rates, can no longer be regarded as merely minor defects. (a) Thus the corporation is denied a full deduction for the interest which it pays under certain circumstances, although the recipient of the interest is taxable, and in the excess-profits tax all borrowed money is excluded from the invested capital which determines the deduction. The result may be complete confiscation of the net profits of a few heavily indebted corporations. (b) Similarly, the individual is denied a complete deduction for losses sustained in collateral transactions outside of his business. His profits from all sources are taxed, but his losses are allowed only when he has collateral gains from which to deduct them. So far as the excess-profits tax is concerned, the law probably admits of administrative correction at this point. (c) Most important of all, the law provides no specific deduction for obsolescence,¹ and by its language plainly debars any recognition of the amortization of war plant and equipment.

The failure of the law to recognize such amortization is a very serious matter at the present time. The government is asking manufacturers in many different lines to erect new plant which will not be needed after the war. The manufacturers insist upon a large amortization allowance before they will undertake the work. Yet the Treasury Department cannot recognize this amortization, because of the plain language and intent of the law. War work is thus being delayed by imperfect tax laws. There is an important lesson here for those who advocate the financing of war by taxes rather than by loans: the lesson that their policy depends for its soundness upon infinite care in the enactment and administration of tax laws. Surveying taxpayers as consumers only, I believe in the conscription of wealth—most people do. But taxpayers are producers as well as consumers, and taxes repress production as well as consumption. Unfortunately also, taxes frequently repress when we do not want repression and in other instances fail to repress when repression would lead to a welcome reduction in the production and consumption of non-essentials.

V. *Some Dicta and Conclusions*

1. Taxation has three principal purposes or results: to raise revenue, to distribute equitably the costs of government, and to

¹ Depreciation is not mentioned *eo nomine* in the statute, but must be read into "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade."

repress production and consumption. As soon as tax rates become high, these three purposes are seen to be almost hopelessly conflicting. If you desire large revenue you cannot indulge in much repression; if you desire much repression you must agree to accept less revenue; and whether you desire much revenue or much repression you must rest content with a modicum of equity.

2. As an instrument of repression the tax is a poor tool. It is not wholly ineffective—you can kill a man with a dull axe. But taxation seldom does repressive work neatly or exactly. The excess-profits tax—or the shadow which it casts before—is now restraining some industries which need expansion, while it fails ignominiously to repress other industries whose labor and capital are solely needed for war work.

3. So clumsy is the tax as an instrument of repression that a strong presumption is created in favor of direct methods, when repression is desired. If we wish seriously to discourage waste, food control, rationing, regulation of restaurants, and the like are better means than taxation. If we seriously desire to repress nonessential industries, priority, restriction of credit, the commandeering of labor and raw material offer better means of accomplishing the desired end than any measure of taxation short of a prohibitive tax designed to kill outright. Taxes may be used legitimately for repression; but they must be used with caution, and when a practical choice is open it is almost always better to select the direct method.

4. At the moment we do need priority—drastic priority; but we do not need more taxes or the talk of more taxes. Before we had either a war or an income tax we talked about the beautiful expansibility of the income tax, the readiness with which it would respond to the financial exigencies of the hour. War came and we had an income tax; but instead of expanding it we talked the maximum rate up to 67 per cent and delayed the collection of the tax until June 15, 1918. (Sixty-seven per cent rates with the bond houses clamoring to sell tax-free securities is rather inconsistent.) Less extreme rates with quicker collection would be a wiser program.

5. The future may bring a pressing need for heavier taxation. If so let us forget our superstitious dread of “retroactive additions” to the income tax, introduce a system of installment payments, shorten the interval between voting the tax and collecting it, and adjust ourselves to the necessity of greater discrimination

in the selection of the subjects and objects of taxation. The personal income tax should be increased in its middle reaches, i.e., rates should be increased upon incomes, say from \$10,000 to \$200,000 a year. With respect to excise and other taxes laid upon business, we must classify and select with infinitely greater care, in the future, the industries and lines of consumption which we wish to restrict. Even then we shall hit some heads which we would fain spare; and to soften the blow we shall be forced to finance private industries to a degree never before anticipated.

6. There has existed among the economists a wholesome prejudice in favor of taxes rather than loans as a method of war financing. Last year at a most opportune time vigorous expression was given to this conviction, with practical results which I cannot but consider as in the main salutary. We did not achieve the actual adoption of a "fifty-fifty program" for the first year of the war, but we did secure a war-revenue bill estimated to yield two and a half billion, of which, according to my rough estimates, 74 per cent will come from taxes upon wealth and ability, 15 per cent from taxes on luxuries or nonessentials, and only 11 per cent from taxes on essential processes and production.

This represents, I believe, a great victory for sound economics. We have not only levied taxes but they are for the most part liberal and democratic taxes. By and large, the result is so good that we must be careful not to undo it. As regards taxes, what happens this year or next is, compared with the long decades of peace which lie before us, comparatively unimportant. During the Civil War the income tax was maltreated, with the result that it was soon repealed and lay unused for nearly forty years. That episode should serve as a warning. We ought for the sake of the long future (of which we academic men are the particular guardians) to refrain from advocating taxes extreme enough to induce reaction. What we need is not so much more taxes as good taxes.

Our presumption in favor of tax financing is largely derived, I believe, from Civil War experience. But at that time the national credit was shaky, we hoped to obtain much money and many supplies from abroad, our banking system was insecure, and prevailing methods of taxation threw the great burden of carrying and extinguishing public debts upon the common people.

Every feature of that situation is different today. We can hope for neither goods nor money from abroad; the national credit

is at par; we have a modern banking system; and our tax system throws the main burden upon the rich. Our vital problems during the Civil War were to protect the public credit and shield the poor from postbellum taxation. We do not need more taxes today merely to protect the public credit; and, so far as the poor are concerned, the most momentous problem before us is to make the adopted system of taxation according to ability such a striking success that it will inevitably be continued after the war. Time was—to exaggerate a little—when the rich bought bonds and the poor paid the taxes. The time may not be far off when the poor will buy the bonds and the rich pay the taxes necessary to carry and extinguish them.

The question of inflation still remains. Personally I do not doubt that loans produce more inflation than taxes. Notwithstanding that fact, we shall finance this war mainly by loans and we shall continue to finance our great wars mainly by loans, until more nearly perfect tax laws have been devised, because the necessity for loans varies with and arises from the imperfections of tax laws. Good taxes may help, but mere taxes cannot cure, the evils of inflation. The real remedy for those evils is the direct remedy; sound banking methods.